Supreme Court of the United States

OCTOBER TERM, 1942.

No.

AIR REDUCTION COMPANY, INCORPORATED,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION

Opinions Below.

The opinion of the Board of Tax Appeals was a Memorandum Opinion, noted at 44 B. T. A. 1348 but not otherwise reported. The opinion of the Circuit Court of Appeals has not yet been reported.

Jurisdiction.

The decree of the Circuit Court of Appeals herein was entered on August 1, 1942 (R. 43). The accompanying petition for a writ of certiorari will be filed on or before October 14, 1942. Jurisdiction to issue the writ is conferred by Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925, and by Section 8(a) of the said Act. The questions involved are important questions of federal law arising under the Revenue Act of 1934.

Statement and Specification of Error.

The questions presented, and the facts upon which they arise, together with the errors alleged, have been set forth in the petition (*supra*, pp. 1-5).

Argument.

I. The question whether a corporation realizes profit or loss, for income tax purposes, on the purchase and sale of its own capital stock is one of wide import and general importance.

In the present case, the petitioner has been held to have realized a taxable profit of over $700,000 because, in issuing 5,258 shares of its own stock in exchange for the last outstanding minority shares of a subsidiary Company, it issued shares which it had previously purchased and was holding as treasury stock. If the petitioner had increased its authorized capital stock by 5,258 shares and had issued the new shares in exchange for the subsidiary company stock, concededly no profit or loss would have been realized. In the case of any large corporation, however, such increases of stock under present statutes relating to notice, proxies, registration, etc., involve considerable delay and substantial expense, all of which was avoided in the present case by the use of shares previously purchased and held as treasury stock. The question whether such use of treasury stock, instead of new stock, affects the corporation's income tax liability is one of general importance and should be passed upon by this court.

Obviously, it made no actual difference to the petitioner (aside from the delay and expense already mentioned) whether it issued new shares or treasury stock. In either case, the assets of the corporation were increased by the remaining shares of the subsidiary company, against which the corporation had 5,258 more of its own shares outstanding in the hands of the public. To hold that the corporation realized profit or loss in the one case but not in the other is to disregard the actual facts and all sound principles of accounting previously recognized by the Treasury Department. Suppose that the situation were reversed

and that the original cost to the corporation of the treasury stock had been $700,000 *more* than the stock (and the subsidiary company's shares) was worth, at the time the stock was re-issued. Would the Treasury Department, or this Court, be prepared to hold that the corporation had sustained a *loss* of $700,000 in thus reissuing the treasury stock, instead of new stock, for the subsidiary company's remaining shares? Yet if there was a $700,000 profit in the one case, it would necessarily follow that there would be a $700,000 loss in the other.

II. As pointed out at length in *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U. S. 110, until the May 2, 1934 amendment the Treasury regulations, commencing with those issued under the 1918 Act, had uniformly provided, in accordance with the great weight of accounting authority, that a corporation realized no profit or loss on the purchase or sale of its own capital stock. Following the 1918 Act, the Revenue Acts of 1921, 1924, 1926, 1928 and 1932 were enacted, without any material change in the statute or the regulations; and as the bill which became the Revenue Act of 1934 had been introduced in Congress and passed by both Houses[1] several months before the amendment of May 2, 1934, there is no ground for claiming that the 1934 Act authorized or approved any change in the established rule that no taxable income was realized from such transactions, under the general definition of gross income contained in that Act and prior Acts.

The statement in the majority opinion below (R. 37-8) that the original regulation had not been followed in all cases by the courts and that the amendment was promulgated for that reason is without any foundation. Some

[1] By House of Representatives, February 21, 1934; by Senate, March 28 1934.

decisions of the Board of Tax Appeals had misapplied the regulation, in cases where a corporation had *received* its own stock in payment for property sold, by holding that the provision that a corporation realized no profit or loss from the *purchase of its own stock* prevented a corporation from being taxed on the profit it received *from the sale of its property,* if it received its own stock as part of the purchase price[1]. The courts, however, had uniformly held in all such cases that, in computing the profit or loss from the sale of the property, the stock so received must be treated as the equivalent of cash, at its fair market value.

Walville Lumber Co. v. *Commissioner,* 35 F. (2d) 445;

Spear & Co. v. *Heiner,* 54 F. (2d) 134, affd. 61 F. (2) 1030;

Commissioner v. *S. A. Woods Mach. Co.,* 57 F. (2d) 635, rev'g 21 B. T. A. 818, cert. den. 287 U. S. 613;

Commissioner v. *Boca Ceiga Development Co.,* 66 F. (2d) 1004.

To the same effect, decided after the amendment:

Dorsey Co. v. *Commissioner,* 76 F. (2d) 339, cert. den. 296 U. S. 589;

Allyne-Zerk Co. v. *Commissioner,* 83 F. (2d) 525;

Hammond Iron Co. v. *Commissioner,* 122 F. (2d) 4.

What was held in those decisions was specifically covered in the next to the last sentence of the amended regula-

[1] e. g., *Houston Brothers Co.,* 21 B. T. A. 804, immediately followed by *S. A. Woods Machine Co., id.* 818, which went so far as to hold that a corporation which received its own stock in payment of damages in an infringement suit received no taxable income.

tion (Appendix C, p. 18, *infra*), providing that gain or loss in such cases was to be computed in the same manner as though the payment had been made in any other property; and that sentence could equally as well have been added to the original regulation, without any change in the provision that a corporation realized no profit or loss from the sale or purchase of its stock.

The change made in the body of the regulation was a paraphrase of certain dicta in *Commissioner* v. *S. A. Woods Mach. Co.* (*supra*). The amendment did not mention treasury stock and, when first promulgated, was apparently intended to cover only cases where a corporation was "dealing in" its own stock as it might in shares of another corporation (i. e., regularly buying and selling its own stock for the purpose of making a profit). It was so construed in the first published ruling involving the amendment (G. C. M. 12955, XIII-1 C. B. 107); and such limited application is apparently the only one for which there is any accounting authority whatever.[1]

It is submitted that there is no sound ground for construing the amendment as applicable to other cases,[2] and that, if it could be construed as applying to the present case, the amendment was arbitrary and unreasonable and not warranted by law.

III. The sale of treasury stock to petitioner's officers bore no resemblance to dealing in the shares of another

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[1] The only authority to that effect cited in the Government's brief below was Montgomery (also cited in G. C. M. 12955, *supra*), in 66 Journal of Accountancy, page 112, replying to May, *id.*, page 17. *Contra*, see authorities cited in *Helvering* v. *R. J. Reynolds Tobacco Co.* (*supra*) and compilation of authorities, including S. E. C. Accounting Series, Release No. 6, in "Income Tax Aspects of a Corporation's Dealings in Its Own Shares," Univ. of Pennsylvania Law Review, May, 1941, pages 934, 953-9.

[2] In the *Reynolds Tobacco Co.* case (*supra*), the corporation was apparently dealing in its own stock, within the meaning of the amendment; and in *Allen* v. *National Manufacture & Stores Corp.*, 125 F. (2d) 239, *cert. den.* May 4, 1942, the corporation had bought its own stock on margin and later sold it at a profit, although the original intention had been to retire the stock eventually.

corporation, as pointed out in the dissenting opinion below (R. 42). Moreover, no actual profit was made on those sales, since the option price was the actual average cost to the petitioner of the treasury stock which it then held (R. 17). The alleged profit resulted solely from the application of the arbitrary and artificial "first-in, first-out" rule.

IV. It is further submitted that the issuance of the treasury stock for the remaining outstanding minority shares of a subsidiary company was expressly exempt from tax, under the relevant reorganization provisions of the Revenue Act of 1934 (Appendix A, pp. 14-15, *infra*) and that the decision of the court below conflicts upon that point with the decision of the Third Circuit in

Commissioner v. *Dana,* 103 F. (2d) 359.

In the case cited, the Spicer Manufacturing Company owned approximately two-thirds of the stock of the Salisbury Axle Company, the remaining one-third being owned by Dana. In 1929, Dana exchanged his Salisbury stock for Spicer stock, reporting no profit on the ground that the transaction was an exempt exchange under the reorganization provisions of the Revenue Act of 1928. The 1928 Act [Sec. 112(i) Appendix A, pp. 15-16, *infra*] defined a reorganization as including the acquisition of a majority of the stock of another corporation, instead of 80% of the stock as required in the 1934 Act; and the Commissioner claimed that since the Spicer Company already owned a majority of the stock of the Salisbury Company, the acquisition of the remaining stock from the sole minority stockholder was not a reorganization within the terms of the statute. The Board of Tax Appeals unanimously held the transaction within the statutory exemption (36 B. T. A. 97); and their decision was unanimously affirmed by the Circuit Court of Appeals (*supra*).

In the present case, the petitioner had previously acquired 87,275 shares of the subsidiary's stock in exchange for its own stock, so that the acquisition of the last 22,347 shares by the transaction in question brought the total number of shares acquired solely in exchange for petitioner's own stock to 109,622 shares, or over 82% of the stock of the subsidiary company. Neither in the present case nor in the *Dana* case was there any written plan of reorganization.

The Court below held that the transaction did not come within the reorganization sections because the petitioner had also acquired the remaining 18% of the subsidiary's stock by cash purchases (R. 41), citing "Cf. *Helvering* v. *Southwest Consolidated Corp.*, 315 U. S. 194." The latter case did not deal with the acquisition of stock. It dealt with the acquisition of the *properties* of another corporation in exchange, not only for stock, but for cash and warrants as well. Hence, as this Court pointed out, the transaction did not come within the terms of the 1934 Act, since the exchange was not solely for voting stock.

Where, however, as in the present case, over 80% of the *stock* of another corporation is acquired solely in exchange for voting stock, that is all that the statute requires. If the petitioner had never acquired any of the remaining 18% of the stock, there could be no question but that the acquisition of 82% of the stock brought the case squarely within the terms of the statute. Obviously, it was not taken out of the terms of the statute by the fact that the petitioner had at various times acquired the remaining 18% of the stock by cash purchases. Such incidental cash purchases of stock which cannot be acquired by exchange are a common feature of almost all reorganizations; and if, as the Court below has held, such incidental cash purchases take the case out of the statute even where the required amount of stock has been acquired solely in

exchange for voting stock, the question is one of great general importance which should be passed upon by this Court.

V. It is submitted that, for the reasons just pointed out, the decision of the Court below on the first issue is in conflict with the decision of the Circuit Court of Appeals for the Third Circuit on the same matter and is based upon a misapplication of the decision of this Court in the *Southwest Consolidated* case (*supra*), and that both issues herein present federal questions of general importance which have not been, but which should be, decided by this Court.

VI. The petition for a writ of certiorari herein should be granted.

Washington, D. C.,
October 14, 1942.

Respectfully submitted,

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